CREDIT RISK MANAGEMENTOFNEPALESE COMMERCIAL BANK

A Thesis Proposal

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1. Background of the Study:

Commercial banks are in the risk business. In the process of providing financial services, they assume various kinds of risks among which credit risk covers the significant portion of the total risk. While commercial banks have faced difficulties over the years for a multitude of reasons, the major cause of serious banking problems continues to be directly related to the lax credit standards for borrowers and counterparties, poor portfolio risk management, or a lack of attention to changes in economic or other circumstances that can lead to deterioration in the credit standing of a bank's counterparties. Since the exposure to credit risk continues to be the leading source of problems in commercial banks world-wide, the banks should now have a keen awareness of the need to identify, measure, monitor, manage and control the credit risk as well as determine that they hold adequate capital against these risks and that they are adequately compensated for the risks incurred.

Concisely, Bank is a financial institution, which deals with money by accepting various types of deposits, disbursing loan and rendering various types of financial services. It is the intermediary between the deficit and surplus of the financial resources. Banking when properly organized, aids and facilitates growth on trade and considered not as dealers in money but as the leader of development. "Bank are not just the storehouse of the country's wealth but are the reservoirs of resources necessary for economic development." *(Radhaswami and Vasudevan, 1991)*

Though the banking sector has been facing different types of risks, major banking problems have been either explicitly or indirectly caused by the weaknesses in credit risk management. So, in this study will be mainly focused on the credit risk management of the commercial banks in Nepal.

According to the Nepal Rastra Bank Unified Directives 2005, the major sources of risk are credit risk, liquidity risk, foreign exchange risk, and interest rate risk and operation risk etc.

The researcher has selected Kumari Bank Ltd (KBL) and Machhapuchhre Bank Limited (MBL) as the samples for the study. Since their date of establishment and the size of capital are also quite similar, these two banks are chosen for study. Both the banks are in the growing stage; but in order to achieve their expected growth target, these banks must be able to manage the various risks, especially, the credit risk.

1.2. Statement of Problem and Research question

One of the major challenges is the government's policy of total liberalization of the banking industry from fiscal year 2018/19 A.D, which has allowed the foreign banks to operate their branch in Nepal without joint venture of Nepalese investors. This has resulted in the increased pressure for Nepalese commercial banks to face the competition of foreign banks. Similarly, Nepal Rastra Bank (NRB) directives to commercial banks to increase the paid-up capital to Rs. 8 billion by 2017 has challenged most of the commercial banks in Nepal. Further, the issuance of new 16 unified directives by the NRB in 2005 has also provided the commercial banks different measures related to credit risk, interest rate risk, foreign exchange risk, liquidity risk and operation risk coupled with maintaining adequate capital to safeguard the interest of investors, depositors and shareholders. The commercial banks need to comply with these prudential's, which have also provided the challenges to the commercial banks of Nepal. Among these, the loan loss provisioning and capital adequacy measures have been providing the major challenges to Nepalese commercial banks. That are why; the researcher has mainly focused on the credit risk.

This research is mainly conducted in order to find the solution for the following questions. The solution is explained through presentation of data in next chapters. The main questions are

1. How much is portion of credit risk in Nepalese commercial banks

2. Is these risks manageable?

3. What is the structural frame work of commercial banks to minimize the credit risk?

1.3. Purpose of the Study

The major purpose of this study on measurement and comparison of credit risks of the selected commercial banks i.e. MBL and KBL, analysis of Credit Risk Management systems and practice followed by the Nepalese Commercial Banks by taking KBL and MBL as the sample banks, the analysis of the directives of Nepal Rastra Bank issued to commercial banks and also is focused on finding out if the banks have taken proper measures to be adequately compensated for the credit risk they hold.

The specific purposes of this study are:

I. To examine the credit risk position of Nepalese commercial banks.
II. To identify the indicators of credit risk management of Nepalese commercial banks.
III. To mitigate the credit risks management present in the commercial banks on the basis of NRB guidelines.

1.4. Significance of the study

As this research is made mainly to analyze the credit risks and their management in reference to NRB directives and measures, it will provide valuable insight to different stakeholders about the major problems of banks and bank's action for its management. The key stakeholders who will be largely facilitated by this research includes,

I. Policy makers will also be benefited as this paper identifies the problems in credit risk management and identifies the need for formulation of new policies or amendment of old policies.
II. Investors, depositors, borrowers also know about the credit risks with these banks to carry out business.

1.5. Limitations of the Study

The outcome of the study is an individual effort. Therefore management, resource mobilization and time constraints limit the in-depth study of all commercial banks operating except commercial banks under study.

I. The evaluation is made through the analysis of financial statement published and presented by the banks. Therefore, generalization of the whole banking industry cannot be made.
II. The secondary data of only five years are taken i.e. from 2014/15 to 2018/19. Inaccessibility of sufficient information also limits the conclusion drawn from study.

2. Review of Literature

The research will be reviewed from various related studies and NRB directives for the study. Firstly, the review on the concept, types of risk and credit risk management will be briefly discussed. Main focus of this study will be an analysis of the directives of Nepal Rastra Bank related to Credit Risk Management of Commercial Banks. The directives issued from time to time are one of the tools used by the central bank to control and monitor the commercial banks. In the present context, the directives are issued by NRB quite regularly. In 2005, NRB, by using the rights given by the Nepal Rastra Bank Act 2058, has issued unified directives to regulate all three categories of financial sectors in Nepal to ensure that the banking industry functions as per the international standard and also to have more effective control mechanism for overall financial sector.

Published as well as unpublished research and thesis related to subject matters of this research will also be reviewed in order to picture out the actual environment of credit risk at these two commercial banks.

Risk refers to uncertainty on the investment faced by the investors. It is the possibility that actual outcomes may be different from those expected. Risk can be defined as the possibility of deviation of the actual return from the expected return. Kupper (2000) defines risk as the volatility of corporation's market value. Risk management, on the other hand, is the process of measuring or assessing risk and then developing strategies to manage the risk. In general, the strategies employed include transferring the risk to another party, avoiding the risk, reducing the negative affect of the risk, and accepting some or all of the consequences of a particular risk.

i. Credit Risk

Credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. Anthony Saunders defines the credit risk as "the risk that the promised cash flows from loans and securities held by FIs (Financial Institutions) may not be paid in full". Credit risk involves inability or unwillingness of a customer or counterparty to meet commitments in relation to lending, trading, hedging, settlement and other financial transactions. Santomero (1997) views credit risk is generally made up of transaction risk or default risk and portfolio risk.

ii. Market Risk

Market risk is the risk incurred in the trading of assets and liabilities due to changes in interest rates, exchange rates, and other asset prices. So, Market risk is exposure to the uncertain market value of the firm's asset

iii. Operational risk

Operational risk is associated with the problems of accurately processing, settling, and taking or making delivery on trades in exchange for cash. It also arises in record keeping, processing system failures and compliance with various regulations. The Basel Committee on Banking Supervision, Basel September (2000), defines operational risk as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events

Lawrence (2nd Quarter, 2006) has taken Basel II as a big opportunity for risk management. There are three stages in the credit process: the first is the simple risk control of the business- avoiding being over concentrated in any one sector, estimating the probability of defaulting and assessing recovery. In emerging markets, such as China, collection and recovery processes have to be better understood. The legal governance structure of liens has to be vastly improved and this will come in time with the new legal regulations being legislated. However, banks cannot afford to count on the legal system as has been painfully learnt from the Netting cases or the sovereign jurisprudence. These are operational risks that must be taken account of.

The second phase is the link between economic capital and return. Clearly banks would like to set minimum rates of return they expect to earn on their portfolios after provisioning. The link between economic profit and risk is the next stage in advancing the practice of credit risk management.

3. Research Methodology

Research methodology describes the methods and process applied in the entire aspect of the study. The main objective of this research will be to measure the credit risk of the selected commercial banks and to study the various management techniques and principles used by the Nepalese commercial banks to manage the credit risk

3.1. Research Design

This study is the combination of descriptive and analytical type of research. Historical data are used to identify and analyze the credit risk of a bank in the past period. Similarly, management system, organizational structure and policies for mitigating the credit risk and the credit risk management procedures have been presented in descriptive form so as to identify the current status from which pitfalls can be identified. From collection of past data and information from key informants, the credit risk management system has been analyzed and recommendations have been made for improving the credit risk management of banks. Since only two banks have been selected for the study, this study is a comparative study between these two banks in credit risk.

3.2. Population and Samples

Since the research topic is about credit risk management of commercial banks, all the commercial banks of Nepal form population of the study. The population for the study comprises all 27 Nepalese commercial banks. Among the total population of 27 only two commercial banks are taken as sample for the comparative study. The sample is chosen with an objective to find out the credit risk management system of new commercial banks, which have completed 6 years. MBL and KBL are taken for the study as there exists similarities between these banks in many respects such as capital base, profit, deposit, lending and date of establishment etc.

3.3. Sources of Data and Collection Procedure

For this study, both primary and secondary data are used. Secondary data are collected mainly from published sources like annual reports, prospectus, newspaper, journal, Internet and other sources. Secondary data published in the annual reports of concerned organizations are collected through personal visit in respective organization as well as from their web sites. For the credit risk analysis, information will be collected through questionnaire. Besides this, interview will also be taken from key officials of KBL and MBL respectively.

3.4. Data Processing and Presentation

The data obtained from the different sources are in raw form. The raw data is processed and converted into required form. For this study, required data are taken from the secondary source (bank's publication) and presented in this study. For presentation, different tables and charts are used. Besides this, primary data collected from different sources, are also presented whenever required. Raw data are attached in annexure. Computation has been done with the help of scientific calculator and computer software program.

3.5. Data Analysis Tools

In order to get the concrete results from the research, data are analyzed by using different types of tools. As per topic requirements, emphasis is given on statistical tools like Arithmetic Mean, Standard Deviation, Default Probability, and Hypothesis Test rather than financial tools.

4. Chapter Plan

The whole study has been divided into five main chapters, each devoted to some aspect of the study concerned with research of Risk Management of commercial Bank in Nepal. The titles of the chapter are as follows;

Chapter I: Introduction It is the introductory part of the study. This chapter describes the general background of the study, focus of the study, statement of the problem, objectives of the study, rationale of the study and limitations of the study

Chapter II: Review of Literature

It includes a discussion on the conceptual framework and review of the related and pertinent literature available. The conceptual considerations and review of related literature conducted in this chapter provides a framework with the help of which the study has been accomplished.

Chapter III: Methodology

This chapter describes the research methodology employed in the study. In this chapter, research design, nature and sources of data, methods of data collection and tools and techniques of data analysis are discussed.

Chapter IV: Results.

This chapter consists of presentation and analysis of data, which deals with the empirical analysis of the study and the major findings of the study.

Chapter V: Conclusion

It is the, conclusion of the study. Following sites, materials, books (Published & Unpublished) will be used as reference while doing this work

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